



ARIZONA STATE SENATE
Fifty-Fifth Legislature, First Regular Session

AMENDED

FACT SHEET FOR H.B. 2838

income tax; partnerships; S corporations

Purpose

Effective January 1, 2022, and retroactive to taxable years (TYs) beginning January 1, 2018, establishes an entity-level tax for a partnership or S corporation, commonly referred to as pass-through-entities (PTEs), and allows the partners or shareholders of a PTE to elect to be taxed at the entity level at a rate of 4.5 percent of the applicable taxable income of the PTE for that TY.

Background

A small business corporation that makes an election for a TY under the U.S. Internal Revenue Code (U.S. IRC) is not subject to the corporate income tax. The income of these corporations is generally passed through to each shareholder, who is then taxed under Arizona's individual income tax ([A.R.S. § 43-1126](#) and [JLBC Tax Handbook](#)).

Individual income tax is levied on Arizona residents' taxable income and uses a graduated rate structure, based on the taxpayer's income level. Current statute authorizes various amounts to be added or subtracted when computing an individual's Arizona adjusted gross income (A.R.S. §§ [43-1021](#) and [43-1022](#)).

In 2017, the Tax Cuts and Jobs Act limited the amount of itemized deductions that may be claimed by an individual for state and local taxes paid by each partner, member or shareholder on their federal income tax return to \$10,000 ([P.L. 115-97 § 13531, 115th Congress, 2017](#)).

In 2020, the U.S. Department of the Treasury and the Internal Revenue Service announced their intention to issue proposed regulations to clarify that state and local income taxes imposed on and paid by a partnership or an S corporation are allowed as a deduction in computing the non-separately stated taxable income or loss for the TY ([IRS Notice 2020-75](#)).

The Joint Legislative Budget Committee fiscal note states that H.B. 2838 would have no impact on the state General Fund. At the federal level, there would be a reduction of individual income tax revenues since H.B. 2838 would allow members, partners and shareholders of PTEs to claim their full deduction for state taxes ([JLBC fiscal note](#)).

Provisions

Entity-Level Tax

1. Allows, for TYs beginning January 1, 2018, the partners or shareholders of a business that is treated as a PTE for federal income tax purposes to consent to be taxed at the entity level at a rate of 4.5 percent of the entire portion of the PTE's taxable income attributable to its resident partners or shareholders and the portion of its taxable income derived from sources within Arizona attributable to its nonresident partners or shareholders for that TY.

2. Requires, for TYs beginning January 1, 2018, the amount deducted by the PTE pursuant to the U.S. IRC for the amount paid to the state under the entity-level tax election and taxes that ADOR determines are substantially similar to be added to Arizona gross income when computing Arizona adjusted gross income.
3. Requires the amount added to a PTE's Arizona gross income to be reflected in the partner or shareholder's Arizona gross income and the PTE's Arizona taxable income.
4. Requires the taxable income of a PTE to be computed in the manner used for the individual income tax or a partnership, if the PTE elected to be taxed at the entity level.
5. Requires the election to be made on or before the due date or extended due date of the PTE's Arizona individual income tax return.
6. Allows ADOR, if the PTE does not pay the amount of tax due to ADOR, to collect the amount of tax owed as a result of the entity-level election from the partners or shareholders based on the proportionate share of income that is attributable to each partner or shareholder for Arizona tax purposes.
7. Requires, beginning January 1, 2022, an entity that is treated as a partnership or S corporation for federal income tax purposes that elects to pay the entity-level tax and whose taxable income for the TY is \$150,000 or more in the preceding TY to make estimated tax payments in the same manner as an individual taxpayer.

Credit for Entity-Level Income Tax

8. Establishes the Credit for Entity-Level Income Tax allowed against individual income tax for a taxpayer who is a partner in a partnership or a shareholder of an S corporation that has elected to pay the entity-level tax.
9. Sets the amount of the Credit for Entity-Level Income Tax as the portion of the entity-level tax paid by the PTE that is attributable to the partner or shareholder's share of income taxable in Arizona.
10. Allows the Credit for Entity-Level Income Tax to be carried forward for no more than five consecutive TYs, if the allowable credit exceeds the taxes due or if there are no taxes due.
11. Requires the Joint Legislative Income Tax Credit Review Committee to review the credit in years ending in 1 and 6.

Credit for Income Tax Paid to Another State

12. Allows, for TYs beginning January 1, 2018, a resident taxpayer to claim a credit for the amount of any tax that ADOR determines is substantially similar to the entity-level tax that is imposed by another state with respect to the direct and indirect taxable income attributable to the resident taxpayer from a PTE that is subject to income tax in Arizona.
13. Prohibits the credit allowed to a resident taxpayer from exceeding the amount that would have been allowed if the income were taxed at the individual level and not taxed at the entity level.

Miscellaneous

14. Requires ADOR to adopt rules and prescribe forms and procedures as necessary to administer the entity-level tax election.
15. Contains a purpose statement.
16. Makes technical and conforming changes.
17. Becomes effective on January 1, 2022, retroactive to TYs beginning January 1, 2018.

Amendments Adopted by Committee

1. Removes limited liability companies from the entities that may elect to be taxed at the entity level.
2. Increases the entity-level tax to 4.5 percent.
3. Delays the requirement that a PTE pay estimated tax payments until January 1, 2022.
4. Specifies that the entity-level election applies to the partners and shareholders of a business that is treated as a partnership or S corporation for federal income tax purposes
5. Requires the amount added to a PTE's Arizona gross income to be reflected in the partner or shareholder's Arizona gross income and the PTE's Arizona taxable income.
6. Removes the stipulation that only PTEs whose partners or shareholders are all Arizona residents may make the entity-level tax election.
7. Requires a tax that ADOR determines is substantially similar to the entity-level tax to be added to Arizona gross income when computing Arizona adjusted gross income.
8. Makes technical and conforming changes.

House Action

WM 2/17/21 DP 6-4-0-0
3rd Read 3/3/21 58-1-1

Senate Action

FIN 3/24/21 DPA 5-1-4

Prepared by Senate Research
March 25, 2021
MG/gs